



April 21, 2008

**AGENDA ITEM 7**

**TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE**

- I. SUBJECT:** Policy Review and Consolidation Project – Revision of Fixed Income Policies
- II. PROGRAM:** Fixed Income
- III. RECOMMENDATION:** Recommend to the Investment Committee
- a. Adoption of the Statement of Investment Policy on Global Fixed Income Program (consolidation of Dollar-Denominated Fixed Income and Externally Managed Active International Fixed Income Programs) and Related Repeals
  - b. Adoption of the Statement of Investment Policy on Low Duration Fixed Income Program (consolidation of Dollar-Denominated Fixed Income-Limited Duration and Dollar-Denominated Fixed Income Short-Term Internally Managed Programs) and Related Repeals
  - c. Approval of the Revised Statement of Investment Policy on Lehman Aggregate Program (old name: Self-Funded Healthcare)
  - d. Approval of the Revised Statement of Investment Policy on Treasury Inflation Protected Securities Program
  - e. Approval of the Revised Statement of Investment Policy on Currency Overlay Program

#### **IV. ANALYSIS:**

##### **Background**

The objectives of the Policy Review Project (Project) are (1) to organize and streamline Investment Policy to improve access, clarity and transparency, (2) to provide a consistent Investment Policy framework, and (3) to ensure that the policies will facilitate the on-going CalPERS compliance program.

As part of the Project, staff developed a new Table of Contents (Attachment 1), which is designed to reflect a top-down and cross-asset class organizational approach. In addition, to facilitate the top-down approach, the Committee approved a new overarching Statement of Investment Policy for the Total Fund.

The Project entails a detailed review of each policy with the goal of updating and streamlining the policy, as well as potential consolidation with other related policies. In addition to the goals of updating, streamlining, and consolidating, the review and revisions include the following:

- Removal of delegations from policy. During the Delegations Project, staff reviewed all policies, minutes, and delegations to identify and consolidate delegations. Delegations are now located in consolidated documents.
- Removal of operational and procedural language, which is now located in staff internal procedure manuals.
- Conformance to the new template, developed for purposes of this Project.

The review is a joint effort and includes input from the General Pension Consultant, the CalPERS Legal Office, and the Enterprise Office of Compliance. The policies are being brought forward to the Policy Subcommittee on a phased basis. Fixed Income policies are being presented in this item.

Clean and blacklined versions are provided for each policy. Few substantive changes were made and are highlighted in the sections below. The vast majority of the changes in the policies and attachments were made for the purpose explained above and to enhance clarity.

A summary of the Global Fixed Income policies and recommended Subcommittee action is included as Attachment 2. Wilshire's opinion letter, supporting the policy revisions for all policies presented in this item is included as Attachment 3.

### **Global Fixed Income Program**

The adoption of the Global Fixed Income Program policy will consolidate the Dollar-Denominated Fixed Income Program ("Domestic Program"), and the Externally Managed Active International Fixed Income Program ("International Program").

The substantive changes proposed are:

- Staff is proposing changes to the Permissible Securities in the Domestic Program (Section II.B.9) to add investment grade preferred stock. The preferred stock typically has a fixed coupon but is subordinate to traditional debt securities. As companies increased issuance of these securities, they have been added to the Lehman bond indices that Staff uses as benchmarks.
- Staff is proposing changes to the International Program's Interest Rate Risk (Section II.B.2.) The range was converted to a percentage to be consistent with all Fixed Income Programs and changed from +/-3 years to 35%.

### **Low Duration Fixed Income Program**

The adoption of the Low Duration Policy will consolidate the Dollar-Denominated Fixed Income – Limited Duration and the Dollar-Denominated Fixed Income Short-Term Internally Managed Policies.

The one substantial change is to allow stock repurchase agreements in the Limited Duration Programs (Attachment A1, Section II.D.3 and Attachment A2, Section II.D.3.). This change is recommended to be consistent with the external managers in the Securities Lending Policy on stock repurchase agreements.

### **Lehman Aggregate Program**

The Lehman Aggregate (LA) Program is a mirror image of the Domestic Program except the benchmark is the Lehman Aggregate Index (LAI) instead of the Lehman Long Liabilities (LLL) Index. The LAI has a lower interest rate risk profile than the LLL and was created for the Self-Funded Healthcare Program and the CalPERS Supplemental Income Plans.

There are two suggested substantial changes recommended.

- In LA Policy, Section II.G.2. the non-investment grade percentage was raised from 10% to 20% to be consistent with the Domestic Program.

- Being a mirror image of the Domestic Program, the addition of preferred stock is also being proposed for the LA Program, for the same reasons stated in the Global Fixed Income Program section of this document. These changes are in LA Policy Section, V.D.8.

### **Treasury Inflation Protected Securities Program**

No substantive changes were made.

### **Currency Overlay Program**

Staff is proposing modifications that will either clarify the Currency Overlay Policy or create greater consistency within all Fixed Income Products. A summary of the changes is below:

- In order to clarify the measurement of the objective of the program, Attachment 1, Section I, Performance Objectives and Benchmark now reads: "The means to accomplish this objective is to have a separate account that holds only currency contracts equal to the intended adjustment away from the 25% hedge. The change in the value of these contracts measures performance.
- In order to clarify and create flexibility for the selection of the currency committee, Attachment 1, Section II-A, Approach was changed to: "A Currency staff committee (staff committee), consisting, at a minimum, of the Chief Investment Officer (CIO), and the Senior Investment Officer Fixed Income (SIO) will seek...."
- In order to allow for the passive reduction of currency risk for programs and assets beyond International Equity, Attachment 3, Section I, Performance Objectives and Benchmark now includes: "Any other international program may be passively hedged to reduce risk with the approval of that asset class SIO. Since this is a passive hedge to reduce risk there is no performance objective and hence no benchmark.

### **Other Fixed Income Related Policies**

The following policies have been recently approved by the Policy Subcommittee, and conform to the new template format. These policies are not presented for Subcommittee action.

Policy Name	Approval Date
Credit Enhancement Program	November 13, 2007
Securities Lending	November 13, 2007

**V. STRATEGIC PLAN:**

This item is consistent with the Strategic Plan: Goal VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first to pay benefits and second to minimize and stabilize contributions.

**VI. RESULTS/COSTS:**

There are no material costs associated with this agenda item.

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